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SUBJECT: NEW ZEALAND'S MONETARY POLICY AT ODDS WITH FISCAL POLICY

1) (U) SUMMARY: On April 26 the New Zealand Reserve Bank (NZRB) raised the Official Cash Rate (OCR) by 25 basis points, to 7.75 percent, citing inflationary pressures from increased government expenditures and a sustained housing boom. Financial experts believe this action is likely to push floating mortgage rates, already hovering around 9.8%, through the psychological double-digit barrier of 10%. Fixed rate mortgages have also edged higher in recent weeks, with benchmark two-year rates reaching 8.8%. The increase means that mortgage holders face the highest interest rates in nearly a decade. The OCR rise has also created a 23-year high in the value of the Kiwi dollar, negatively affecting exports and leading a number of export manufacturers to announce they will leave New Zealand for cheaper destinations.

2) (U) Meanwhile, the OECD's 2007 economic survey of New Zealand has rated the NZ economy well in the bottom half of the OECD tables, in large part because of the high value of the Kiwi dollar and high domestic interest rates. The report also cites other weaknesses as New Zealand's large net foreign debt and current account deficit, as well as falling household savings levels. The report maintains that lower government spending would make it easier for the NZRB to curb inflation and stabilize the economy. The economy is by and large still doing fairly well by global standards -- with GDP growth predicted to reach 2% and unemployment remaining at 3.7%. But manufacturers' and exporters' concerns about the high Kiwi dollar and interest rates are already being exploited by the opposition National Party, which blames Labour government's spending for the problems. To help deflect criticism, Labour has asked Parliament to look into ways to control inflation other than just adjusting the OCR. Many analysts say such an inquiry will be a waste of time unless the Government looks at aligning fiscal and monetary policies. End Summary.

Effect of OCR Hike
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3) (U) In announcing the interest rate hike, NZRB head Dr. Alan Bollard attributed his decision to increase the OCR rate to the robust housing market, increases in government spending, a rising gap between the value of imports and exports, ongoing high levels of immigration, and a strong labor market. He also described the strength of the Kiwi dollar as both "exceptional" by historical standards (at a 23 year high) and "unjustified" on medium-term economic data. This was seen as a shot across the bow for the currency markets but the warning was largely ignored, with the dollar

closing that day at US74.81c.

4) (U) Bollard's move prompted manufacturers, unions and political parties to call on the Government to develop other financial measures besides the OCR for controlling inflation. Last week, one of New Zealand,s largest manufacturers of consumer appliances, Fisher & Paykel said it would close its Auckland washing-machine manufacturing plant and shift production to Thailand, with the loss of some 350 jobs. Soon thereafter bed-maker Sleepyhead said it may shift its plant to China, putting another 400 jobs at risk. These lay-offs follow announcements this past month from three large (by NZ standards) Christchurch manufacturers, G. L. Bowron, Click Clack and Whisper Gen, all of which blamed the high NZ dollar for the need to downsize.

5) (U) The interest rate hike comes just days after the OECD warned that GNZ's spending increases were likely to fuel inflation and increase the exchange rate of the Kiwi dollar, which would further exacerbate imbalances in the economy. All eyes are now on Finance Minister Michael Cullen, who is due to unveil the annual Budget in just three weeks time. In it he is expected to include another $1.9NZ billion in new expenditures, including $1bNZ worth of business tax cuts. Analysts expect that if these increases are made the NZRB will raise the OCR rate again at their next meeting in June, to 8 percent.

OECD Adds Fuel to the Fire
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6) (U) NZ's high interest rates have been given the thumbs

down by the OECD as well. In a widely publicized report released on 23rd April, the OECD ranked New Zealand,s economy at 22 out of 30 OECD member countries. "What really matters is that living standards are quite a lot below the OECD median and they don't seem to be catching up," reported Deborah Roseveare, who heads the OECD's New Zealand desk. Despite ranking near the top for its policy and regulatory framework, New Zealand's productivity and saving rates are near the bottom. Roseveare added that the reforms of the 1980s and 90s were essential and had contributed to productivity growth in the past but the OECD is puzzled as to why New Zealand hasn't performed better. Part of the explanation could be the huge swings in the Kiwi dollar's exchange rate, which hinders exports, along with persistently high interest rates, which discourage investment. "It's not obvious what policy makers can do about it," maintained Roseveare.

7) (U) The OECD Economic Survey of New Zealand further indicates that NZ faces the dual challenge of raising national income levels and providing superannuation payments for an aging population. The report says New Zealand needs stronger and deeper financial markets as an alternative to investment in housing, as well as a tax regime that encourages people to work, save and invest. The OECD suggests this goal could be achieved by flatter, more broadly based tax system with lower private income and corporate tax rates and a higher GST level. Or, there could be a dual system which taxes capital gains along with private income. (NB: NZ does not currently have a capital gains tax.) The survey also recommends New Zealand cut the top private tax rate (currently 39% for incomes of NZ$60,000 (US$45,000) and above), raise the GST rate by 1% to 13.5%, raise the age of superannuation entitlement (now 65 years) and find new ways to control inflation other than raising the OCR. The OECD survey concludes that the Reserve Bank will not be able to lower the interest rates that are pushing up exchange rates and household and business costs until the economy slows or foreign investors suddenly lose confidence in New Zealand.

Political and Business Fallout
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8) (U) One of the most politically sensitive remarks in the OECD report claims that, "New Zealand's living standards, whether measured by GDP or net national income per person, lag well behind the OECD mean and median," but more importantly well behind Australia (ranked 9) against whom NZ constantly compares its standard of living. National Party's finance spokesman, Bill English says that the OECD Survey identifies, "Labour's spending binge in the lead-up to the next election as one of the main causes of the high interest rates, inflation, and high exchange rate bedeviling the economy." Not surprisingly, Finance Minister Cullen says the report proves that Labour's economic policies have given New Zealand one of the most flexible and resilient economy in the OECD.

9) (U) Economic Development Minister Trevor Mallard said giving the Reserve Bank new tools to fight inflation, beyond its use of interest rates, would at a minimum require a multi-party accord on monetary policy. He said such an agreement is unlikely, however, given that the last time Labour attempted to involve National in talks over another option - the proposed tax on mortgage rates to slow the housing market - the National Party swiftly condemned it. Mallard also indicated that the Reserve Bank and the Treasury were continuing to look at other ways to supplement the OCR tool. Meanwhile, National's Finance Spokesman Bill English has said he is not convinced other measures would work. National blames high Government spending for NZ's inflationary pressures.

10) (U) The political sniping has drawn Prime Minister Helen Clark into the debate, and on May 2 she endorsed an inquiry by the all-party Finance and Select Committee, chaired by Labour's Shane Jones. The committee may examine capital gains tax or a mortgage rate levy as an alternate means to further NZRB rate hikes. Some pundits believe that neither of the two main parties are likely to adopt these measures but are more likely to focus on tightening tax rules on investment properties and apply more vigilant policing of laws covering

property speculation.

¶11. (U) Prominent business leaders also reacted to the government's response by saying that any inquiry by a parliamentary select committee into the pressures on inflation and the export sector will be a waste of time if the focus is only on monetary policy. They believe the government needs to focus more on productivity-raising measures such as staged tax reductions, freer employment law, less regulation of the business sector, and more private sector involvement in infrastructure and government business enterprises. They maintain that inflation needs to be controlled by reducing the growth in government spending to below the growth rate of the economy so that more resources are available to the productive sector.
McCormick